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## INDECENT BAZAARS

ECONOFICTION CAPITAL, CAPITALISM, DERIVATE, EMERGING MARKETS, FINANCE, PONZI FINANCE

Peripheral markets may be defined as markets which generate only a small proportion of their financial inflows from local business and investors, but which attract the interest of 'global' investors. Emerging markets and markets for financial exotica such as financial derivatives are examples of such peripheral markets. Because emerging markets are largely dependent upon attracting international funds in order to generate increases in securities prices and capital gains which will attract further funds, they are particularly good examples of the principles of **Ponzi finance** at work in securities markets.

A common characteristic feature of peripheral markets is that they have no history of returns to financial investment on the scale on which finance is drawn to those markets in a time of capital market inflation. Such returns in the future have to be inferred on the basis of conjecture and fragmentary information. Investment decisions are therefore more dependent on sentiment, rather than reason. Any optimism is quickly justified by the rapid increase in asset prices in response to even a modest excess net inflow of money into such a market.

Emerging markets illustrate this very clearly. Such markets exist in developing and semi-industrialized countries with relatively undeveloped pensions and insurance institutions, principally because only a small proportion of households earn enough to be able to put aside long-term savings. The first fund manager comes upon such a market in the conviction that a change of government or government policy, or some temporary change in commodity prices, has opened a cornucopia of profitable opportunities and therefore warrants the dismissal of a history of economic, financial and political instability. If he or she is able with buying and enthusiasm to attract other speculators and fund managers to enter the market, they may drive up asset prices and make the largest capital gains. The second and third fund managers to buy into that market also make capital gains. The emulatory competition of trading on reputation while competing for returns makes international investment managers especially prone to this kind of 'herd' investment.

For a while such capital inflows into the market make everyone happy: international fund managers are able to show good returns from the funds in their care; finance theorists can reassure themselves that greater financial risks are compensated by higher returns; the government of the country in which the emerging market is located can sell its bonds and public sector enterprises to willing foreign investors and use the proceeds to balance its budget and repay its debts; the watchdogs of financial prudence

in the International Monetary Fund can hail the revival of finance, the government's commitment to private enterprise and apparent fiscal responsibility; state enterprises, hitherto stagnating because of under-investment by over-indebted governments, suddenly find themselves in the private sector commanding seemingly limitless opportunities for raising finance; the country's currency after years of depreciation acquires a gilt-edged stability as dollars (the principal currency of international investment) flow in to be exchanged for local currency with which to buy local securities; the central bank accumulates dollars in exchange for the local currency that it issues to enable foreign investors to invest in the local markets and, with larger reserves, secures a new ease in managing its foreign liabilities; the indigenous middle and professional classes who buy financial and property (real estate) assets in time for the boom are enriched and for once cease their perennial grumbling at the sordid reality of life in a poor country. In this conjuncture the most banal shibboleths of enterprise and economic progress under capitalism appear like the very essence of worldly wisdom.

Only in such a situation of capital market inflation are the supposed benefits of foreign direct investment realized. Such investment by multinational companies is widely held to improve the 'quality' or productivity of local labour, management and technical know-how in less developed countries, whose technology and organization of labour lags behind that of the more industrialized countries. But only the most doltish and ignorant peasant would not have his or her productivity increased by being set to work with a machine of relatively recent vintage under the guidance of a manager familiar with that machine and the kind of work organization that it requires. It is more doubtful whether the initial increase in productivity can be realized without a corresponding increase in the export market (developing countries have relatively small home markets). It is even more doubtful if the productivity increase can be repeated without the replacement of the machinery by even newer machinery.

The favourable conjuncture in the capital markets of developing countries can be even more temporary. There are limits on the extent to which even private sector companies may take on financial liabilities and privatization is merely a system for transferring such liabilities from the government to the private sector without increasing the financial resources of the companies privatized. But to sustain capital gains in the emerging stock market, additional funds have to continue to flow in buying new liabilities of the government or the private sector, or buying out local investors. When new securities cease to attract international fund managers, the inflow stops. Sometimes this happens when the government privatization drive pauses, because the government runs out of attractive state enterprises or there are political and procedural difficulties in selling them. A fall in the proceeds from privatization may reveal the government's underlying fiscal deficit, causing the pundits of international finance to sense the odour of financial unsoundness. More commonly rising imports and general price inflation, due to the economic boom set off by the inflow of foreign funds, arouse just such an odour in the noses of those pundits. Such financial soundness is a subjective view. Even if nothing is wrong in the country concerned, the prospective capital gain and yield in some other market need only rise above the expected inflation and yield of the country, to cause a capital outflow which will usually be justified in retrospect by an appeal to perceived, if not actual, financial disequilibrium.

Ponzi financial structures are characterized by ephemeral liquidity. At the time when money is coming into the markets they appear to be just the neo-classical ideal of market perfection, with lots of buyers and sellers scrambling for bargains and arbitrage profits. At the moment when disinvestment takes hold the true nature of peripheral markets and their ephemeral liquidity is revealed as trades which previously sped through in the frantic paper chase for profits are now frustrated. This too is particularly apparent in emerging markets. In order to sell, a buyer is necessary. If the majority of investors in a market also wish to sell, then sales cannot be executed for want of a buyer and the apparently perfect market liquidity dries up. The crash of the emerging stock market is followed by the fall in the exchange value of the local currency. Those international investors that succeeded in selling now have local currency which has to be converted into dollars if the proceeds of the sale are to be repatriated, or invested elsewhere. Exchange through the local banking system may now be frustrated if it has inadequate dollar reserves: a strong possibility if the central bank has been using dollars to service foreign debts. In spite of all the reassurance that this time it will be different because capital inflows are secured on financial instruments issued by the private sector, international investors are at this point as much at the mercy of the central bank and the government of an emerging market as international banks were at the height of the sovereign debt crisis. Moreover, the greater the success of the peripheral market in attracting funds, and hence the greater the boom in prices in that market, the greater is the desired outflow when it comes. With the fall in liquidity of financial markets in developing countries comes a fall in the liquidity of foreign direct investment, making it difficult to secure appropriate local financial support or repatriate profits.

Another factor which contributes to the fragility of peripheral markets is the opaqueness of financial accounting in them, in the sense that however precise and discriminating may be the financial accounting conventions, rules and reporting, they do not provide accurate indicators of the financial prospects of particular investments. In emerging markets this is commonly supposed to be because they lack the accounting regulations and expertise which supports the sophisticated integrated financial markets of the industrialized countries. In those industrialized countries, where accounting procedures are supposed to be much more transparent, peripheral markets such as venture capital and financial futures still suffer from accounting inadequacies because financial innovation introduces liabilities that have no history and which are not included in conventional accounts (notably the so-called 'off-balance sheet' liabilities). More important than these gaps in financial reporting is the volatility of profits from financial investment in such peripheral markets, and the absence of any stable relationship between profits from trading in their instruments and the previous history of those instruments or the financial performance of the company issuing them. Thus, even where financial records are comprehensive, accurate and revealed, they are a poor indicator of prospective returns from

investments in the securities of peripheral markets.

With more than usually unreliable financial data, trading in those markets is much more based on reputation than on any systematic financial analysis: the second and third investor in such a market is attracted by the reputation of the first and subsequently the second investor. Because of the direct connection between financial inflows and values in securities markets, the more trading takes place on the basis of reputation the less of a guide to prospective returns is afforded by financial analysis. Peripheral markets are therefore much more prone to 'ramping' than other markets.

Why would such a crisis of withdrawal not occur, at least not on such a scale, in the more locally integrated capital markets of the advanced industrialised countries? First of all, integrated capital markets such as those of the UK, and the US are the domestic base for international investors. In periods of financial turbulence, they are more likely to have funds repatriated to them than to have funds taken out of them. Second, institutional investors tend to be more responsive to pressure to be 'responsible investors' in their home countries. In large measure this is because home securities make up the vast majority of investment fund portfolios. Ultimately, investment institutions will use their liquidity to protect the markets in which most of their portfolio is based. Finally, the locally integrated markets of the advanced industrialized countries have investing institutions with far greater wealth than the developing or semi-industrialized countries. Those markets are home for the pension funds which dominate the world markets. Among their wealth are deposits and other liquid assets which may be easily converted to support a stock market by buying securities. The poorer countries of the world have even poorer pension funds, which could not support their markets against an outflow due to portfolio switches by international investors.

Thus integrated markets are more 'secure' in that they are less prone to collapse than emerging or, more generally, peripheral markets. But precisely because of the large amount of trade already concentrated in the integrated markets, prices in them are much less likely to respond to investment fund inflows from abroad. Pension and insurance fund practice is to extrapolate those capital gains into the future for the purposes of determining the solvency of those funds. However, those gains were obtained because of a combination of inflation, the increased scope of funded pensions and the flight of funds from peripheral markets.

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Foto: Bernhard Weber

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